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SUBJECT: SCENESETTER FOR CODEL REID

¶1. (SBU) Welcome to Peru. Your visit comes at a moment when the new government led by President Alan Garcia is emerging from its honeymoon period and is beginning to feel popular pressure for action. The message from the June presidential election -- a contest in which Hugo Chavez protege Ollanta Humala won just under 50 percent of the vote, scoring big in the highlands, the jungle and among the poor -- was clear: after five years of solid economic growth, a significant swath of Peru's population still feels excluded from the benefits of economic growth, and wants them now.

¶2. (SBU) From his first day in office, President Garcia has shown that he gets the voters' message and is responding. In a high profile government austerity campaign, he has cut the salaries and benefits of government officials. In his foreign travels, Garcia has been careful to minimize expenditures (even flying economy class to the United States for his meeting with President Bush). He has announced an "investment shock" in key sectors like schooling and water delivery. And his administration has proven quick and dexterous in responding to social conflicts in the regions.

¶3. (SBU) Despite these actions, no leader could deliver on such extensive needs in such a short time. Garcia knows that the electorate won't wait for long, and his personal popularity has dropped from a post-election high of 76 percent to the low-50s today. To ensure success over the long term, Garcia will need to strike a balance between meeting social demands and maintaining macroeconomic stability, demonstrating responsiveness to the legitimate demands of Peru's poorest citizens while avoiding the lure of populism.

An Economy Hitting on All Cylinders

¶4. (U) While the challenges are significant, Garcia has some important cards to play. Perhaps the most important is Peru's booming economy, which Garcia inherited from President Toledo. Peru has enjoyed five years of sustained economic expansion -- GDP growth is expected to reach 7 percent for 2006 and exports have more than tripled over the past five years. Growth has cut the poverty rate from 54 percent in 2001 to 48 percent today. Extreme poverty -- those living on less than \$1 per day -- declined from 24 percent to 18 percent during the same period.

¶5. (U) Peru's growth has been private-sector generated, export-led, and largely powered by increased trade with the United States (thanks to the Andean Trade Preferences

Act--APTDEA). The United States is Peru's top export destination, absorbing almost a quarter of all the country's exports. From 2001- to 2006, Peru's exports to the U.S. tripled to USD 5.4 billion. Garcia knows the importance of the U.S. to Peru's economy and is therefore committed to trade liberalization. He has made obtaining U.S. congressional approval of the Peru Trade Promotion Act a top priority. His government also seeks to strengthen its ties with neighboring Latin American countries. For example, Peru and Chile expanded their Economic Complementation Agreement this year, and Peru is close to completing free trade agreements with both Chile and Mexico.

Favorable Political Elements

¶6. (SBU) Garcia's second great asset is political skill, both his own and that of his team, which has lent Peru a stability the country has not enjoyed for several years. The President's Prime Minister, Jorge del Castillo, has proven to be an effective "fireman," dousing social conflicts in the regions by brokering deals between factions. Beyond this, the President has adeptly balanced popular initiatives with budgetary restraint and respect for macroeconomic stability.

¶7. (SBU) To square sectoral demands for spending with macroeconomic stability, Garcia frequently launches proposals that sound more populist than they really are. For example, in September Garcia announced that military officers accused of human rights violations can get their legal defense funded by the state. Later, the Minister of Defense noted that if those same officers are found guilty, they have to reimburse the government the cost of that defense. So far, this Two-Step has worked well for the President, enabling him to address sectoral demands but avoid budget-busting consequences.

¶8. (U) In addition, the President has encountered a more cooperative Congress than anticipated. Though APRA does not constitute a majority, the other parties have not hardened into opposition. Rather, congressional coalitions have formed on an issue-by-issue basis, enabling the President largely to control the agenda.

How Long a Honeymoon?

¶9. (SBU) While Garcia's honeymoon continues, we see significant challenges on the horizon. The President's party took a drubbing in recent elections for regional presidencies (APRA dropped from controlling 12 to 3 regional governments). A crop of locally-based political leaders took over most regional governments, some of them radicals and many with little proven administrative experience. Some analysts believe Garcia can work this to his advantage, using an ongoing program of decentralization to foist the responsibility (and blame) for programs on regional governments that ultimately depend on the GOP for most of their budgets. Others maintain that program failures -- whether the fault of the GOP or Regional Presidents -- will inevitably blow back on the central government.

¶10. (SBU) Garcia's second concern is the fate of the Peru Trade Promotion Act in the U.S. Congress. When you meet with him, the President will express his anxiety over its passage, and unease about the likely consequences to his personal credibility and the standing of his government if it does not. The agreement is popular in Peru (and has become even more so since the Peruvian Congress approved it in June). Garcia knows access to the U.S. market has been the key element to Peru's recent economic growth. Uncertainty over the Peru Trade Promotion Act's approval could cut the economy's growth rate, reduce job-creation (both critical to the President's efforts to meet the needs of dissatisfied social sectors) and cause Garcia to lose political ground to radicals who sympathize with Venezuelan President Hugo

Chavez.

¶11. (SBU) Beyond these political hazards, Garcia faces an even larger challenge. The President is an acknowledged master of political tactics, but observers doubt he has the political will to undertake the kind of state reforms needed for Peru to make the leap to the next level of development. In particular need of reform are a corrupt judiciary that moves at a glacial pace, a public education system in disarray, and an Army shaken by scandals over malfeasance demand far more than smartly-timed, short-term measures.

Garcia and Latin America

¶12. (SBU) In the regional context, Garcia will have to strike a balance between radical populist impulses and responsible economics similar to the one he seeks to maintain on the domestic front. On the one hand, Garcia aspires to lead a loose group of moderate, market-friendly leaders -- some but not all from historically leftist parties -- who are disposed to work closely and cooperatively with the United States. These include the Presidents of Mexico, Colombia, and Chile. On the other hand, Garcia will tread carefully with Venezuelan President Hugo Chavez and his regional allies, seeking to reduce surface tensions with Chavez and to avoid being seen as subordinate to the U.S. In this context, Garcia might act in ways that reflect his immediate tactical interests (as when he embraced the Venezuelan President at a recent meeting of South American Presidents on Cochabamba, Bolivia) rather than Peru's longer term strategic priorities.

¶13. (SBU) Through all this, we should keep in mind that an array of concrete interests aligns Peru and the United States and divides Peru from Venezuela. Chavez' "Bolivarian" vision for Latin America opposes the free-market model of growth to which Garcia is committed. Chavez' frequent fulminations against other Latin American leaders, and his pull-out from the Andean Community of Nations (CAN), undermine the positive regional integration (one that engages the United States) Garcia envisions. Garcia shares none of Chavez' sympathy for the FARC, which he sees as Colombian version of Peru's Sendero Luminoso and MRTA. Finally, Chavez' promotion of his Bolivarian ideology and his petro-financed meddling in Peruvian politics, on ample display throughout the April-June presidential campaign, are profoundly unsettling to a Peruvian President who is trying to satisfy urgent social needs in responsible fashion. Consequently, while Garcia will try to avoid head-to-head confrontations with Chavez, basic national interests drive the Presidents of Peru and Venezuela in fundamentally different directions.

An Interest-Based Alliance

¶14. (SBU) Garcia is an enormously skilled politician who has inherited an economy that depends on the U.S. for much of its free-market growth. He hopes to satisfy pressing social needs within the framework of responsible macroeconomic and fiscal policy. He aspires to lead a group of countries who see the U.S., not as a problem, but as a partner in development. Taken together, these factors make Alan Garcia's Peru the United States' best ally in South America after Colombia.

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